

## Customer Account Statements

### FINRA Requests Comment on Proposed Amendments to NASD Rule 2340 to Address Values of Unlisted Direct Participation Programs and Real Estate Investment Trusts in Customer Account Statements

Comment Period Expires: November 12, 2011

#### Executive Summary

FINRA is proposing amendments to NASD Rule 2340 (Customer Account Statements) to address how firms report the per share estimated values of unlisted Direct Participation Programs (DPPs) and unlisted Real Estate Investment Trusts (REITs) on customer account statements.<sup>1</sup> The amendments would limit the time period that the offering price may be used as the basis for a per share estimated value to the period provided under Rule 415(a)(5) of the Securities Act of 1933 (Initial Offering Period). The amendments also would require firms to deduct organization and offering expenses from per share estimated values during the Initial Offering Period. The amendments would prohibit a firm from using a per share estimated value, from any source, if it “knows or has reason to know the value is unreliable,” based upon publicly available information or nonpublic information that has come to the firm’s attention. Finally, the amendments would allow a firm to omit a per share estimated value on a customer account statement if the most recent annual report of the DPP or REIT does not contain a value that complies with the disclosure requirements of Rule 2340.<sup>2</sup>

Questions regarding this *Notice* may be directed to:

- ▶ Joseph E. Price, Senior Vice President, Corporate Financing/Advertising Regulation, at (240) 386-4623;
- ▶ Gary L. Goldsholle, Vice President and Associate General Counsel, Office of the General Counsel, at (202) 728-8104; or
- ▶ Paul Mathews, Director, Corporate Financing Department, at (240) 386-4639.

#### September 2011

##### Notice Type

- ▶ Request for Comment

##### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

##### Key Topics

- ▶ Customer Account Statements
- ▶ Unlisted Direct Participation Programs (DPPs)
- ▶ Unlisted Real Estate Investment Trusts (REITs)

##### Referenced Rules & Notices

- ▶ FINRA Rule 2231
- ▶ FINRA Rule 2310
- ▶ NASD Rule 2340
- ▶ NASD Rule 5110
- ▶ Regulatory Notice 09-09
- ▶ Rule 415 under the Securities Act of 1933

## Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by November 12, 2011.

Member firms and other interested parties can submit their comments using the following methods:

- ▶ Emailing comments to *pubcom@finra.org*; or
- ▶ Mailing comments in hard copy to:  
Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

**Important Notes:** The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments on its site one week after the end of the comment period.<sup>3</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be approved by the SEC, following publication for public comment in the *Federal Register*.<sup>4</sup>

## Background

NASD Rule 2340 generally requires each general securities member firm to send account statements to customers at least quarterly. The account statements must include a description of any securities positions, money balances and account activity since the firm issued the prior account statement. A firm that does not carry customer accounts and does not hold customer funds or securities is not a general securities member firm and is not subject to the provisions of Rule 2340.

NASD Rule 2340(c) contains specific provisions addressing the estimated values of DPPs and REITs on customer account statements.<sup>5</sup> The rule generally requires that a general securities member firm include an estimated value for a DPP or REIT security held in a customer's account. The rule states that the per share estimated value included on a customer account statement may be obtained from the annual report, an independent valuation service or any other source. The rule requires that firms develop a per share estimated value on a

customer account statement from data that is not more than 18 months old.<sup>6</sup> The rule also requires a firm to remove or amend a per share estimated value if the firm can demonstrate that the value was inaccurate as of the date of valuation or is no longer accurate as a result of a material change in operations.

FINRA Rule 2310 (Direct Participation Programs) prohibits a firm from participating in a public offering of a DPP or REIT unless the general partner or sponsor represents that it will include a per share estimated value in each annual report.<sup>7</sup> The current industry practice is to use the value in the issuer's annual report as the per share estimated value on a customer account statement.

*Regulatory Notice 09-09* addressed the use of the offering price, or "par value," as the basis of the per share estimated value required under NASD Rule 2340. The *Notice* discussed the interplay between the use of the offering price from the annual report and the requirement that the per share estimated value on a customer account statement be developed from data that is not more than 18 months old. The *Notice* explained that 18 months after the conclusion of the offering, the per share estimated value must be derived from an appraisal of the issuer's assets and operations, and may not simply be a restatement of the aged offering price.

## Proposed Amendments<sup>8</sup>

### Presenting Per Share Estimated Value, Net of Organization and Offering Expenses

The estimated value of an illiquid security such as a DPP or REIT may be derived from several sources. An appraisal of the issuer's assets and operations will assist investors in understanding the value and relative performance of the DPP and REIT over time. However, in the earlier stages of an offering of a DPP or REIT, as it accumulates assets, the net offering price can be a suitable alternative, particularly since an appraisal would involve recently acquired assets and cash that is yet to be invested during the ramp-up period. Appraisals also may be expensive depending on factors such as the nature and geographic dispersal of assets. In consideration of these concerns, FINRA proposes to permit valuations based on the offering price during the Initial Offering Period when the program is acquiring assets and firms are selling shares at a stable value on a best-efforts basis. However, FINRA proposes to amend the rule to require that all per share estimated values, including those that are based on the offering price, reflect a deduction of all organization and offering expenses (net value).<sup>9</sup>

Under Rule 2310(a)(12), organization and offering expenses consist of expenses incurred in connection with registration and distribution, including all forms of compensation paid to broker-dealers and affiliates in connection with the offering. Rule 2310 generally limits organization and offering expenses to 15 percent of the gross proceeds of an offering.

These expenses have three components: (1) issuer expenses that are reimbursed or paid for with offering proceeds, (2) underwriting compensation, and (3) due diligence expenses.

While any value of an illiquid security is an estimate, netting out the offering expenses is likely to be a closer approximation to the intrinsic value, particularly since the up-front fees and expenses reduce the amount of the investable capital during the ramp-up period when the assets are acquired by the DPP or REIT.<sup>10</sup> Requiring net values on customer account statements during the Initial Offering Period will provide greater transparency to investors about the fees and expenses, which would benefit investors.<sup>11</sup>

### Close of Initial Offering Period and Appraised Values

Rule 415(a)(5) provides that certain types of registered securities, including DPPs and REITs, may be offered and sold if no more than three years have elapsed since the initial effective date of the registration statement. Under Rule 415(a)(6), the Securities and Exchange Commission may make another registration statement for a DPP or REIT effective for a second three-year offering period. If a new registration statement is filed, Rule 415(a)(5) (A) permits securities covered by the prior registration statement to continue to be offered and sold until the earlier of the effective date of the new registration statement or 180 days after the third anniversary of the initial effective date. Under the proposed amendments, the three-year period under Rule 415(a)(5) and any “carryover period” under Rule 415(a)(5) (A) constitute the Initial Offering Period in NASD Rule 2340.

FINRA proposes to limit the period during which a per share estimated value based on the net offering price may be included on an account statement to the Initial Offering Period. Beyond the Initial Offering Period, the volatility in the value of the underlying assets of a DPP or REIT can cause the value to deviate substantially from the initial offering price, rendering the net offering price a poor estimate of the per share estimated value. After the Initial Offering Period, the basis for a per share estimated value included on a customer account statement must be based on an appraisal of a DPP or REIT’s assets, liabilities and operations.

The proposed amendments eliminate the provision in NASD Rule 2340(c)(2) that requires firms to develop a per share estimated value from data that is no more than 18 months old.

Instead, the proposed amendments require the data that serves as the basis for a per share estimated value to be no less current than the data in the most recent annual report. If a per share estimated value is available that is more recent than the value in the annual report, member firms can disclose that value if it meets the requirements of Rule 2340.<sup>12</sup>

## Reliability of Estimated Values

Rule 2340 currently requires a member firm to remove or amend a per share estimated value if the firm can demonstrate that the value was inaccurate as of the date of valuation or is no longer accurate as a result of a material change in operations. The proposed amendments adjust this requirement to prohibit a firm from using a per share estimated value, from any source, if it “knows or has reason to know the value is unreliable,” based upon publicly available information or nonpublic information that has come to the firm’s attention.

The proposed amendments also allow a firm to omit the per share estimated value if the most recent annual report of the DPP or REIT does not contain a value that complies with the disclosure requirements of the rule. In the alternative, a firm could decide to provide a reliable value from a source other than the annual report that meets the rule’s requirements. The amendments would require, however, that if a per share estimated value does not appear in or has been removed from a customer account statement, the firm must disclose the reason the value does not appear or has been removed.

## Endnotes

1. Unlisted DPPs and unlisted REITs do not trade on a national securities exchange. DPPs are defined in FINRA Rule 2310 and offer investors an equity interest in an entity such as a limited partnership that provides flow-through tax consequences and distributes income generated from underlying assets. REITs are defined in Section 856 of the Internal Revenue Code and are pass-through entities that offer investors an equity interest in a pool of real estate assets, including land, buildings, shopping centers, hotels and office properties. The definitions of DPP and REIT in NASD Rule 2340(d)(3) and (4) exclude securities listed on a national securities exchange as well as securities that are in a depository and settle regular way. The definition of DPP also excludes any program registered as a commodity pool.
2. NASD Rule 2340 only applies to customer account statements, as defined by that rule. Rule 2340, and as proposed to be amended, would not apply to annual statements of the fair market value of assets provided by retirement account trustees and custodians under Internal Revenue Service Regulations, including Section 1.408-2(e)(5)(ii)(E).
3. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See *NTM 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.

© 2011 FINRA. All rights reserved. FINRA and other trademarks of the Financial Industry Regulatory Authority, Inc. may not be used without permission. *Regulatory Notices* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

4. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
5. NASD Rule 2340 applies to DPPs and REITs regardless of whether they are listed or itemized “above the line” or “below the line.” The term “below the line” means that securities and other assets are reported on the account statement, but are not in the possession of the member. New platforms that provide processing for alternative investments may result in DPPs and REITs being reported more frequently above the line because the securities are in the possession of member firms.
6. NASD Rule 2340(c) also requires that account statements provide: (1) a brief description of the estimated value, its source and the method by which it was developed; and (2) disclosure that the investment program securities are generally illiquid securities and the estimated value may not be realized when investors seek to sell the security. Additional disclosure are required if the account statement does not provide an estimated value.
7. Section 13(a) of the Securities Exchange Act requires annual reports to be distributed to investors.
8. As part of the rulebook consolidation process, FINRA has proposed new FINRA Rule 2231 to replace NASD Rule 2340. See SR-FINRA-2009-028. The amendments discussed herein would be made to NASD Rule 2340 or new FINRA Rule 2231, depending upon the timing of SEC approval.
9. Some REITs have begun to calculate a daily net asset value (NAV). The selling price per share is based on the daily NAV calculation and typically includes a selling commission. Under the proposal, the net estimated value required on customer account statements for such programs would be the NAV and could not include any commissions, nor any other organization or offering expense associated with the offering.
10. If any organization and offering expenses are to be deducted from portfolio assets or income, then under the proposal the net estimated value would have to reflect those deductions that will be taken during the Initial Offering Period, in addition to the deduction for organization and offering expenses paid out of proceeds from the offering.
11. *Regulatory Notice 09-09* reminded firms of their obligation under the suitability rule to determine the amount of dividend distributions that represents a return of investors’ capital and whether that amount is changing. In addition, firms must consider whether there are impairments to the real estate investment program’s assets or other material events that would affect the distributions and whether disclosure regarding dividend distributions needs to be updated to reflect these events.
12. Firms would not be required to immediately update the per share estimated values shown in customer account statements when a new value appears in the annual report. However, firms must use reasonable efforts to address operational or technical requirements associated with updating per share estimated values, to ensure that the updating occurs as promptly as practicable. Firms that require more than one statement cycle to update the per share estimated values are likely to raise a presumption that the firm is not making reasonable efforts.

## Attachment A

Below is the text of the proposed amendments to Rule 2340.

### 2340. Customer Account Statements

#### (a) General

No change.

#### (b) Delivery Versus Payment/Receive Versus Payment (DVP/RVP) Accounts

No change.

#### (c) Unlisted DPP/REIT Securities

(1) A general securities member that holds a direct participation program (DPP) or real estate investment trust (REIT) security in a customer's account must provide a per share estimated value of such security on the account statement as provided below:

(A) The customer account statement must disclose:

(i) the source of the per share estimated value, which may be from the annual report, independent valuation service or any other source, and the manner in which the per share estimated value was calculated, and

(ii) that unlisted DPP or REIT securities are illiquid securities and that the per share estimated value may not be realized when the customer seeks to liquidate the security.

(B) During a period not to exceed the period provided under SEC Rule 415(a)(5) since the initial effective date of the first registration statement under which the DPP or REIT is offered and sold (Initial Offering Period), any per share estimated value based upon the offering price must reflect a deduction of the amount of organization and offering expenses, as defined by FINRA Rule 2310(a)(12).

(C) After the Initial Offering Period, only a per share estimated value calculated based on an appraisal of the assets, liabilities and operations of the DPP or REIT and derived from data no less current than the data in the most recent annual report may be disclosed.

(2) Notwithstanding the requirements in paragraph (1):

(A) A member must refrain from providing a per share estimated value, from any source, if it knows or has reason to know the value is unreliable, based upon publicly available information or nonpublic information that has come to the member's attention; and

(B) A member may refrain from providing a per share estimated value if the most recent annual report of a DPP or REIT does not contain a per share estimated value that complies with the requirements in paragraphs (1)(B) or (1)(C).

**(3)** For any member refraining from providing a per share estimated value as permitted in paragraph (2), the customer account statement must disclose that:

(i) unlisted DPP or REIT securities are illiquid;

(ii) the value of the security is different from its purchase and may be less than the purchase price

(iii) an estimated valuation of the security is unavailable; and

(iv) the reason the value does not appear in, or has been removed from, the account statement.

**(d) Definitions**

No change.